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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH, Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

In the matter of KENT MAERKI and NORMA JEAN COFFIN aka NORMA JEAN MAERKI, aka NORMA JEAN MAULE, husband and wife, DENTAL SUPPORT PLUS FRANCHISE, LLC, an Arizona limited liability company Respondents.	DOCKET NO. S-20897A-13-0391 **MEMORANDUM** **FRANCHISES AS SECURITIES**

On March 17, 2015, Administrative Law Judge Stern ("ALJ") issued the Thirteenth Procedural Order ordering the parties to file a memorandum on how the franchises described in the Notice of Opportunity are securities. The Securities Division alleges that the program offered and sold by Dental Support Plus Franchise ("DSPF") are securities under the Arizona Securities Act ("Act"). As outlined below, the DSPF "franchises" offered and sold by the Respondents are investment contracts as defined under the Act.

MEMORANDUM OF POINTS AND AUTHORITIES

I. Introduction

At hearing, the Securities Division must establish that the testimony and evidence support a finding that the Respondents' "franchise" investment program, are securities, in the form of an investment contract, under the Act. "[T]he definition of security embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). When interpreting the Act, "substance

controls over form." *Nutek Information Systems, Inc. v. Arizona Corporation Commission*, 194 Ariz. 104, 108, ¶17, 977 P.2d 826, 830 (App. 1998).

The intent and purpose of the Act is "protection of the public, preservation of fair and equitable business practices, the suppression of fraudulent or deceptive practices in the sale or purchase of securities, and the prosecution of persons engaged in fraudulent or deceptive practices in the sale or purchase of securities. This Act shall not be given a narrow or restricted interpretation or construction, but shall be liberally construed as a remedial measure in order not to defeat the purpose thereof." 1951 Ariz. Sess. Laws ch. 18, § 20.

The evidence and testimony will establish that although the Respondents labeled the investment product as a "franchise" it was nothing but an investment contract designed to get around the Act. Therefore, as described by the *Nutek* Court, the Respondents are those who devise schemes who seek to use of the money of others on the promise of profits. *Supra.* The Act was designed to protect the public from individuals who disguise securities in non-securities titles to avoid the Act.

II. Respondents Offered And Sold Investment Contracts Disguised As Franchises.

Although the Respondents labeled the investment scheme as a "franchise," the manner in which the "franchises" were offered, sold and operated constitutes an investment contract under the Act. The definition of security under the Act includes the term "investment contract" without defining it further. The Supreme Court defined the term investment contract as an investment of money in a common enterprise with profits to come solely from the efforts of other. *See S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946).

Arizona Courts have recognized the "*Howey*" test to define investment contract under the Act. In *S.E.C. v Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482, (1973) cert denied 414 U.S. 821 (1973), recognizing that the Supreme Court's "definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather it must be construed realistically, so as to include within the

definition those schemes which involve in substance, if not form, securities. *Id.* Further, the Court adopted a more realistic test; "whether the efforts made by those other than the investor are the undeniable significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Id.*

Applying the *Howey* test and the analysis made by the Ninth Circuit in *S.E.C. v. Glenn Turner*, to the facts outlined in the Notice of Opportunity filed in this case, there is no question that Respondents offered and sold securities in the form of investment contracts.

The Securities Division will establish that all elements of the *Howey* test are met through the presentation of evidence and testimony.

A. First Element of Howey - Investment of Money.

The first element of the *Howey* test is the investment of money. The evidence will show that beginning in 2011 through 2013, investors purchased their "franchises" starting at $20,000 per "franchise." The price was increased to $25,000 and then to $30,000. Investors purchased their "franchises" using cash or IRA transfers. The Securities Division will present evidence and testimony from investors on how they wired funds or issued a check to DSPF for the purchase of the "franchises." The Securities Division will present evidence that Respondents received more than $12 million through the sale of "franchise" interests to investors. There is no question that the first element of *Howey* is met.

B. Second Element of *Howey* – Common Enterprise.

The second element of the *Howey* test is common enterprise. At the time it issued its opinion in the *Howey* case, the Court did not define the term "common enterprise." Subsequent courts have recognized two tests to determine common enterprise; vertical or horizontal commonality. In Arizona, the second element of *Howey* may be met through either horizontal or vertical commonality. *See Daggett v. Jackie Fine Arts, Inc.*, 152 Ariz. 559, 566, 733 P.2d 1142, 1149 (Ariz. App. 1987).

Vertical commonality requires a correlation between the success of the investor and the success of the promoter without the requirement of pooling. *Id. Daggett* at 565. The promoter's success is tied to the investors. Such a correlation can be satisfied by an arrangement involving a seller or even a third party who is different from the promoter. *See S.E.C. v. R. G. Reynolds, Inc.*, 952 F.2d 1125, 1130 (1991). The Court in *R. G. Reynolds, Inc.* found that "one indicator of vertical commonality, . . . is an arrangement to share profits on a percentage basis between the investor and the sell or promoter." *Id.*

The Securities Division will introduce evidence, from the Respondents' own records, and testimony from Respondent Maerki, that if the investors do not make money on their "franchise" purchase, the Respondents do not make money. *See* Securities Division Proposed Exhibit S-7a[1], Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 119, lines 1 – page 120, lines 3. According to Respondent Maerki's sworn testimony, "nobody gets paid any money unless the franchise does . . .. In other words, the franchisor doesn't get paid until that cash flow starts through. Oracare[2] doesn't get paid until it starts through. They've spent the setup and marketing cost. Metro Media[3] doesn't get paid. It's all designed to get paid by performance." *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 157, lines 18 – 24. The investors pay Metro Media 29% of the money they receive from the dentists. They are to pay the franchisor 4% and Oracare 19%. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 90 lines 3 – 10.

The Respondents sales practices disclosed that their approved venders and entities owned and controlled by the Respondents receive a percentage of the returns paid to the investors. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 119, lines 1 – page 120, lines 3. Neither the Respondents nor the

[1] The Securities Division did not Docket its proposed exhibits. If the ALJ issues a procedural order requesting that the proposed exhibits to be docketed, the Securities Division will comply.
[2] Oracare Development, Inc. ("Orocare")
[3] Metro Media Business Services, Inc. ("Metro Media")

approved venders receive any compensation unless the investor receives returns on their investments. The investors do not have to pay for services of the approved venders if they do not see a return. In a newsletter to investors, Respondent Maerki stated "[f]ranchises have not been profitable, and as a result, DSPF has not been profitable." *See* Securities Division Proposed Exhibit S-61b, Bates Number ACC124155-157, Memorandum from the Desk of Kent Maerki.

Horizontal commonality involves the pooling of investor funds managed by the promoter or third party. The Securities Division will submit Proposed Exhibit S-61a, Opportunity Alert and Investment Offering Document, ACC122446 – 122456, that establishes horizontal commonality. DSPF's National Field Sales Manager, Daryl Bank, owns Dominion Private Client Group. *See* Securities Division Proposed Exhibit S-61a, Letter Announcing the Dental Support Group, ACC122431-33. According to Dominion Private Client Group, investors are able to purchase franchises or interests in a pool of franchises. *See* Securities Division Proposed Exhibit S-61a, Opportunity Alert, ACC122446. Respondent Maerki is included in the offering document provided to investors. *See* Securities Division Proposed Exhibit S-61a, DSPF Group Investment Offering Document, ACC122454.

Respondents' investment program meets the requirements of common enterprise. Vertical commonality is present. Respondent Maerki's own statements support finding vertical commonality. In addition, horizontal commonality is met through the offering of pooled franchises.

C. **Third Element of *Howey* – Expectation of Profits.**

The *Howey* test requires that the investor must have an expectation of profits. The Securities Division must establish that the investors expected profits from their purchase of the "franchises." The investors will testify that they purchased "franchises" with the intent to earn a profit as represented in the offering materials and by the salespeople. The Respondents were very successful selling this investment program as an "absentee-owned" program. According to one email an offeree received, DSPF offers an "[a]bsentee owned, fully-managed dental franchise with

a 5-year track record producing annual profits up to 40% to 60%, or more." *See* Securities Division Proposed Exhibit S-9, Email from Info@dspf.co, ACC000013. The same email represented that "a fully leveraged franchise may produce annual profits up to 108.42%, or more, within 2 years. *See* Securities Division Proposed Exhibit S-9, Email from Info@dspf.co, ACC000014.

The Securities Division will present testimony from investors that they only purchased the "franchises" to make a profit. The Respondents offered and sold the "franchise" to investors with the expectation of profits.

D. **Fourth Element of *Howey* – Through the Efforts of Others.**

The *Howey* Court found that the expectation of profits must be solely from the efforts of others. *See S.E.C. v. W.J. Howey Co.,* 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). The Ninth Circuit found that the efforts must be undeniably significant ones; that is, those essential managerial efforts which effect the failure or success of the enterprise. *See Sullivan v. Metro Productions, Inc.*, 150 Ariz. 573, 724 P.2d 1242 (Ariz. App. 1986); *S.E.C. v Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482, (9th Cir. 1973) cert denied 414 U.S. 821 (1973). The efforts of others do not need to be those of the promoters. *See Daggett v. Jackie Fine Arts, Inc.*, 152 Ariz. 559, 566, 733 P.2d 1142, 1149 (Ariz. App. 1987).

Arizona courts recognize that "others" can be third parties not just the promoter or seller. *See Daggett,* 152 Ariz. at 566, 733 P.2d at 1149. The Ninth Circuit Court in *Hocking v. Dubois*, 839 F.2d 560 (9th Cir. 1988), refined "others" in its landmark opinion. In that case the offering included an optional "collateral arrangement" with a third party manager who was unreferenced in the sale document and who was without any affiliation, selling arrangement or link with the seller. *See Hocking*, 885 F.2d at 1457, 1460-62. The court held this was sufficient to satisfy the "efforts of others" element, if the third party collateral arrangement was "presented" to the investor "as part of the same transaction or scheme, and that he purchased them as such." *Id.* at 1458.

In this case, the "franchises" were offered and sold as "absentee-owned" investments. *See* Securities Division Proposed Exhibit S-7c, Dental Support Plus Franchise Tri-fold Brochure,

ACC002281. The investors were given the choice to operate the "franchise" themselves or to retain the venders approved by the Respondents. Between 2010 and to mid-2012, Metro Media was only approved vender for obtaining patients. Between 2010 and mid-2012, Oracare was the only approved vender for obtaining dentists. In mid-2012, Respondents created Dental Support Group LLC as another approved vender. According to the information provided to the investors, if the investors retained the marketing company to be responsible for operating the business, the investors' only responsibility would be to reconcile monthly reports with accounts, oversight and taxes. *See* Securities Division Proposed S-Exhibit S-7c, Dental Support Plus Franchise Tri-fold Brochure, ACC002281. The Respondents offered an approved vender that would handle the reconciliation, oversight and taxes to the investors.

The testimony at hearing will establish that the investors had no desire to run the day to day operations of the "franchise." A large portion of the investors were retired individuals who did not want to start a new career in the dental field. In addition, Respondent Maerki testified that everyone who purchased the "franchise" program chose the managed program except one. The only person to attempt to operate their own "franchise" was Respondent Maerki himself. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 58, lines 6 -15.

Hocking clarified that "others" includes not just the promoter or seller and affiliated third parties, but even third parties without any legal relationship with either seller or investor at the time the investment is made. The Court in *Hocking* stated that "[w]hat determines the applicability of the securities laws here is *what* tangible bundle of rights was actually offered to or purchased by the buyer, not *who* offered or sold those rights to him." *Id.* at 569. The Courts look to substance of a transaction rather than the form.

In this case, the evidence will show that all the investors (except Respondent Maerki) chose to retain the approved venders. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 58, lines 6 -15. Orocare and Metro

Media were part of the offering materials. Orocare and Metro Media received a portion of the "franchise" fees paid by investors. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 155, lines 4 – 11. The representations about DSPF's track record related to the principals of Orocare and MetroMedia, not Respondents. *See* Securities Division Proposed Exhibit S-7a, Examination Under Oath transcript of Kent Maerki dated July 11, 2012, page 132, lines 9 – page 133, lines 7.

The Securities Division met its burden establishing the fourth element, through the efforts of others.

III. Conclusion

The evidence and testimony will show that all the elements of the *Howey* test were met. The Respondents offered and sold securities in the form of investment contracts. As case law dictates, look to substance over form.

RESPECTFULLY SUBMITTED this 1st day of June, 2015.

Wendy Coy, Staff Attorney for the Securities Division

SERVICE LIST FOR: KENT MAERKI and NORMA JEAN COFFIN aka NORMA JEAN MAERKI, aka NORMA JEAN MAULE, husband and wife, DENTAL SUPPORT PLUS FRANCHISE, LLC

ORIGINAL and 9 copies of the foregoing
filed this 1st day of June, 2015, with:

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COPY of the foregoing hand-delivered
this 1st day of June, 2015, to:

The Honorable Marc E. Stern
Administrative Law Judge
Arizona Corporation Commission
1200 W. Washington St.
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